SUPREME COURT, U. S.

No. 70-60

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

versus

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER

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Argument

I.

The mere fact that the sole shareholder of a corporation participates in a securities fraud on the board of directors does not prevent a liquidator from suing on behalf of the insolvent corporation under Section 10(b).

Respondents have argued that because there was but a single stockholder of Manhattan who participated in and ratified the fraud, the petitioner may not maintain a cause of action under Section 10(b). (See e.g. B.L. br. at 12; I.T.

br. at 18-20; B.A. br. at 26-29).* The authorities relied on by respondents do not support this argument.

In *Field* v. *Lew,* 184 F. Supp. 23 (E.D.N.Y. 1960) *aff'd. sub nom' Field* v. *Bankers Trust Co.,* 296 F.2d 109 (2nd Cir. 1961), cert. denied, 369 U.S. 859 (1962), a case heavily relied on by respondents, the District Court held that a corporation has no right of action *in conversion* based upon a fraud by its president and sole stockholder because he ratified the fraud. In affirming the District Court, the Court of Appeals in *Field* v. *Bankers Trust Co., supra,* did not consider this specific holding. It must be noted that the *Field* case involved state common law, did not involve a fraud in connection with a securities transaction, and had nothing to do with Section 10(b) or any other section of the federal securities acts. That case presented no allegations of deceit and material misrepresentations made to the board of directors, which is a material allegation of this Section 10(b) action. For the same reason, *Cunningham* v. *Jaffe,* 251 F. Supp. 143 (D.S.C. 1966) and *General Hatters Supply Co.* v. *Hartman,* 148 N.Y.S. 2d 90 (Sup Ct., N.Y. Co. 1955), also relied on by respondents, are inapplicable to the instant case.

In the only Section 10(b)5 case to consider the question of corporate estoppel resulting from shareholder ratification, the Court of Appeals for the Fifth Circuit recently held in a well reasoned opinion that a trustee in bankruptcy is not estopped from suing on behalf of the corporation where all of the stockholders, directors and officers ratified the fraud by means of their participation in it. *Bailes* v.

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* The briefs of respondents are referred to herein as follows: Bankers Life and Casualty Company, B.L.; Irving Trust Company, I.T.; Belgian-American Banking Corporation and Belgian-American Bank and Trust Company, B.A.; George K. Garvin and Garvin Bantel & Company, G.

Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971). Contrary to respondents' contention that the Court of Appeals for the Fifth Circuit cited no authority for the trustee's right to sue (B.A. br. at 28) and that *Bailes* was in conflict with federal common law as enunciated in *Old Dominion Copper Mining and Smelting Co.* v. *Lewisohn*, 210 U.S. 206 (1908) (I.T. br. at 21), we note that the *Bailes* decision relied on the holding in *McCandless* v. *Furland*, 296 U.S. 140 (1935), which in effect overruled *Old Dominion*. See dissenting opinion at 296 U.S. 173. *McCandless* held that the receiver of a bankrupt corporation had standing to recover for the unlawful depletion of corporate assets whereby the company was made insolvent and the creditors were defrauded of their lawful rights and remedies. The defendants there were the promoters and sole shareholders.

Mr. Justice Cardozo, writing for the Court, set forth the following language which disposes of the argument advanced by respondents:

> "It was not within the power of the shareholders to legalize this waste to the detriment of others. It would not have been within their power to bring that result to pass, though shareholders and promoters had been different persons, acting at arm's length. Still more clearly it was not within their power when shareholders and promoters were in substance the same persons. Cf. *California-Calaveras Mining Co.* v. *Walls*, 170 Cal. 285, 299, 149 P. 595; *Pittsburgh Mining Co.* v. *Spooner*, 74 Wis. 307, 42 N.W. 259, 17 Am. St. Rep. 149. Consent in such conditions, so far as it gives approval to conduct in fraud of the rights of others, is a word and nothing more. It is not in concord with realities." *McCandless, supra*, 296 U.S. at 160.

The consent of shareholders can never be operative where the consent is in derogation of the public policy of the State

or the prohibition of a statute. *McCandless, supra,* 296 U.S. at 162. Any alleged consent by the sole shareholder of Manhattan was in derogation of the prohibition against fraud in connection with the purchase or sale of a security contained in Section 10(b).

II.

Petitioner has standing to sue under Section 10(b) on behalf of the defrauded corporation and on behalf of its creditors and policyholders.

In *Bailes, supra,* defendants incorporated American Publishing Company and caused it to issue to them (through Colonial Press, Inc., their wholly owned corporation) 412,000 shares of stock for essentially valueless consideration. The stock was then registered with Alabama's Securities Commission and sold to the public. There were many instances of overstatement of assets and understatement of liabilities. The Court held that the trustee in bankruptcy on behalf of the corporation could maintain a 10b-5 action if acts it was caused to perform operated as a fraud or deceit upon itself or upon others—including subsequent creditors or subsequent holders of claims for taxes. *Bailes,* 444 F.2d at 1246.

The record demonstrates the manner in which Manhattan, through its board of directors, was defrauded. But petitioner also has standing to sue on behalf of Manhattan because the creditors of Manhattan were deceived within the meaning of Section 10(b). The opinion in *Bailes* is particularly appropriate:

> "It could be anticipated that, in reliance on these misrepresentations, some of these persons would extend credit in one form or another to American South-

> ern which they might well have refrained from extending had they known the true state of the corporation's finances. *The corporation was thereby exposed to the risk that it would be caused to assume liabilities to creditors which, but for the misrepresentations, it would not have assumed, and which ultimately it would be unable to satisfy due to the absence of the $412,000.00 it was represented to, but did not, possess.*" *Bailes, supra,* 444 F.2d at 1245-1246 [emphasis added].

Potential creditors and policyholders of Manhattan were justified for over one year in believing that Manhattan had a net worth which included the $5,500,000.00 it was misrepresented to have deposited with Belgian Trust. Manhattan was therefore exposed to the same risk as the corporation in *Bailes, supra,* in that it would be caused to assume liabilities to creditors which, but for the misrepresentations, it would not have assumed and which ultimately it was unable to satisfy.

Petitioner further maintains that, looking at the entire scheme, Manhattan was the victim of fraud in connection with the purchase or sale of securities. Since Manhattan was fraudulently purchased with its own assets (the proceeds from the sale of the Treasury bonds), Manhattan was a constructive purchaser of its own stock. As Judge Hays stated in dissent:

> "Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock [to Begole], it seems to me to be completely unrealistic to say that the fraud was not committed 'in connection with the purchase or sale of any security' ". *Superintendent of Insurance v. Bankers Life and Casualty Co.,* 430 F.2d 355, 362.

Reliance by Irving Trust on *Schoenbaum* v. *Firstbrook,* 405 F.2d 215 (2d Cir. 1968) (en banc) cert. denied *sub nom. Manley* v. *Schoenbaum,* 395 U.S. 906 (1969) (I.T. br. at 15) for the proposition that one requirement of a corporate 10(b)5 action is shareholder injury was misplaced where, as here, the board of directors was deceived. Both the panel and the en banc decisions in *Schoenbaum* recognized that if the board of directors were deceived, a corporate cause of action existed. In *Schoenbaum,* however, no director was deceived, thereby distinguishing it from the case at bar.

Respondents incorrectly assert that petitioner is not suing on behalf of Manhattan's creditors and that petitioner does not claim any injury to any creditor of Manhattan. (See I.T. br. at 23; B.L. br. at 13, 17; B.A. br. at 16, n 3, 26, 28). Respondents have been on notice, at least since 1968, in a proceeding before the District Court, that petitioner sues on behalf of Manhattan and its creditors and policyholders See plaintiff's memorandum in opposition to motions pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure (Record, Document No. 441) at 3, 20, 34, 42-43, 48. Indeed, this fact is admitted by Bankers Life in its brief at page 13.

The Superintendent of Insurance of the State of New York is charged with:

> "The preservation and enhancement of Company assets to the end that the interests of all of its creditors, policyholders, stockholders and the public be subserved." *Knickerbocker Agency* v. *Holz,* 4 N.Y. 2d 245, 253, 173 N.Y.S. 2d 602, 609 (1958).

The provisions of the New York State Insurance Law for the liquidation of insolvent companies are exclusive in their operation and are designed to furnish a complete procedure for the protection of all parties. New York Insur-

ance Law, Art. V, Section 93; Art. XVI, Section 510, *et seq.; In re Lawyer's Title & Guaranty Co.*, 254 App. Div. 491, 5 N.Y.S. 2d 484 (1938), reargument denied, 9 N.Y.S. 2d 126 (1938). The petitioner represents the creditors and policyholders of Manhattan and will prove at trial injury to them resulting from respondents' fraud. It is unnecessary to discuss at this time the extent of damages to the creditors of Manhattan. Petitioner has established its case by showing that the votes necessary to authorize the sale of the bonds were obtained by means of materially misleading representations. That is sufficient to defeat the motion. The question of relief and the extent of damages is to be determined by the District Court at trial. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384, 386-389 (1970).

When a bankruptcy trustee sues on behalf of a corporation, he also sues on behalf of its creditors. In both *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), and *Bailes, supra,* the Court of Appeals for the Fifth Circuit permitted trustees in bankruptcy to sue under Section 10(b) on behalf of the defrauded corporation where the creditors of that corporation would be the direct beneficiaries of any recovery obtained by the trustee. See also, *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963). Likewise, the petitioner is entitled to recover on behalf of Manhattan under Section 10(b) where its creditors and policyholders will benefit from the recovery.

Trustees in bankruptcy have successfully sued under Section 10(b) on behalf of defrauded corporations apart from the rights of any minority shareholders to sue. *Bailes, supra; Hooper, supra; Pettit, supra.* The courts have recognized that although the corporate cause of action could be prosecuted without the benefits extended by

the Exchange Act, the procedural and jurisdictional difficulties in connection with such an action would be many and could easily frustrate effective recovery by the insolvent estate. *Hooper, supra,* 282 F. 2d at 201; *Pettit, supra,* 217 F. Supp. at 28.

That petitioner has standing to sue on behalf of the corporation in connection with the sale of Treasury bonds was recognized in the Court of Appeals. Petitioner has established his standing to sue on behalf of the corporation in connection with the purchase and sale of Manhattan stock. In addition, petitioner has standing to sue on behalf of the creditors of Manhattan. See petitioner's main brief at 29-35 and the brief for the Securities and Exchange Commission as *amicus curiae* at 26-29.

III.

Reply to misstatement of fact contained in the brief of Garvin, Bantel and Company and George K. Garvin.

The briefs of respondents contain various misstatements of fact. Petitioner deems it essential to point out the most glaring inaccuracy so that the correct record of events is before the Court.

The brief of Garvin, Bantel concedes at 3 the logic and merit of petitioner's argument concerning the deceit practiced on the board of directors of Manhattan. It then contends that the argument is inconsistent with the factual allegations—that in petitioner's state court complaint at A.128a it is alleged that Begole appointed all the members of the board and therefore the board was not an independent decision making body rendering any deception on it of no practical effect. Nowhere on the page Garvin, Bantel cites to is there a reference to any ap-

pointments of directors to the board. The state complaint referred to alleges at A.129a that Begole and Sweeny were elected directors and nothing more. Furthermore, if the board of directors was a rubber stamp of Begole's, it would have been unnecessary to fraudulently induce it by misrepresentations to authorize the sale of portfolio bonds. We respectfully direct the Court's attention to the testimony of the directors of Manhattan and other exhibits set forth at A.115a-123a. Those pages clearly demonstrate the deception practiced on the board of directors of Manhattan in connection with the sale of its portfolio of bonds.

CONCLUSION

For all of the reasons set forth herein, in petitioner's main brief, and in the brief for the Securities and Exchange Commission as *amicus curiae*, the decision of the Court of Appeals should be reversed.

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